Engaging with State Street Global Advisors

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Key Takeaways

State Street Global Advisors is evolving its proactive and targeted approach to engagement, prioritizing climate change, human capital management (HCM) and diversity equity and inclusion, and expanding its stewardship team

Plans to publish new guidelines on HCM and effective climate transition disclosures, focusing on how companies will achieve their Net Zero commitments and encouraging interim progress on GHG reduction goals

Considering modifications to its director overboarding policy that would allow exceptions to current guidelines if boards provide disclosure of their policies for outside board service and how board contributions are evaluated

Refining its views on executive compensation, with a focus on encouraging increased exposure to the company's stock price over time and guidance for inclusion of ESG metrics

<u>**Approach to Stewardship and Engagement**</u>

Erica Lukoski: Ben, you've been at State Street Global Advisors (SSGA) for three years and in your role as Global Co-Head of Asset Stewardship for almost two years. Can you tell us about your path to SSGA and your current position?

Ben Colton: I've been in corporate governance for more than a decade. I started my career at Norges Bank Investment Management, working in Oslo for almost five years and then in New York City for three years. I joined State Street Global Advisors in 2018 as Asia-Pacific Head of Asset Stewardship, based in Japan. I always say that this global context is important as it has informed my view of stewardship but it is also reflective of how our team is structured.

We have analysts in three regions — APAC, EMEA, and the Americas — and among these teams we have a considerable amount of overlap when it comes to how we cover companies. The stewardship team is not siloed based on sectors — we have subject-matter experts who focus on social issues, those who focus on environmental topics and others who specialize in governance topics. The common factor is that everyone is involved in voting and engagement.

Similar to how we share our view with companies on the importance of diversity of thought, we also encourage diversity in our team in terms of perspectives, geographies and backgrounds. We believe it is to our advantage to debate and deliberate across the team, which helps us be consistent in our approach. We have expanded the team in 2021 and expect to considerably grow headcount in 2022.

Erica: How does this team structure support your approach to engagement?

Ben: Over the past year and a half we have shifted our engagement program toward a more targeted and outcome-oriented approach that is focused on issues we believe are financially material. We are prioritizing engagement based on our thematic priorities which encompass 1) Emerging ESG trends 2) Our clients' portfolio exposure 3) Developing macroeconomic conditions and regulation and 4) Insights derived from our R-Factor™ scores.

Even though we won't be able to engage with every company, we have other means of communicating with our portfolio companies that we believe are effective. This includes the thought leadership we publish such as the annual CEO letter to board members highlighting our stewardship priorities, quarterly vote disclosure alongside our quarterly stewardship reports, a multi-year outline of our key voting policies in Q1 and our R-Factor™ program. We view all of these as part of our engagement program because each play a role in communicating our approach to these issues and provide a roadmap for companies to move their own practices forward.

In addition, there are a number of issues that we want to do deeper dives on — climate change, HCM and human rights — and we have shifted our approach to be more proactive in our engagement on those topics. For example, earlier this year, we sent letters to 35 of the largest employers in the US and UK, across sectors, as part of a new initiative on HCM practices. We met with many of these companies several times to really understand and gather information on best practices, challenges, expectations and what the future looks like.

We've used that due diligence to develop a well-vetted and thoughtful approach. Based on this, we'll be publishing best practices and expectations about what good HCM disclosure looks like and also where companies may fall short.

Erica: How are you prioritizing with whom you engage and what are the best ways for companies to get your attention when they want to discuss particular topics?

Ben: We are doing fewer engagements with companies where we have no outstanding concerns, there is significant information in the public domain or the issue that the company wants to engage on is related to a clear-cut policy that we have in place. But that doesn't mean that we do not want to hear from companies that have issues that they want to raise with us. We are working to improve our engagement tracking capabilities and moving forward in 2022, intend to respond to all incoming requests within a week of receipt.

To that end, we encourage companies to send their engagement requests to the full team because it means there will be more eyes on that request. Sending a note to a single analyst means that if that person misses it then no one will see it. The best practice from our standpoint is to email the full team distribution and provide context in the email body. For example: *"Dear Governance Team, we would like to schedule an engagement following up on a conversation we had with Michael during proxy season. We saw that you supported the HCM proposal and note that this topic is a thematic priority for State Street. We would like to dive deeper to understand your views and share our practices."*

Erica: How frequently are active managers joining stewardship team engagements and what is the catalyst for them to join meetings?

Ben: Our active teams have access to our internal stewardship platform and are able to get visibility into our upcoming engagements which they may choose to join depending on the topic and expected attendees. That typically includes meetings in which they have access to board members or the executive management team or in discussions related to contested situations. They also participate in meetings more frequently in the off-season when we dive deeper into long-term strategy and its link to specific ESG issues. While proxy voting responsibility ultimately lies within the stewardship team, our active teams are integrated into the voting process and systematically provide us with their recommendations and perspectives.

Erica: When do you want to engage with directors and what should every director know before they engage with SSGA?

Ben: We are looking for directors to demonstrate robust ESG knowledge and be conversant on how topics like climate change and diversity are linked to company strategy. We want to know how the board tracks progress, how the board helps determine which ESG issues are material to the company and how the board holds management accountable for ESG commitments.

As it relates to executive compensation, for example, we don't find it relevant to hear what a company's compensation consultant recommended — we care about what the compensation committee members think. We are often engaging with the same board member for two or maybe even three CEO transitions. We value

the relationship we have with directors in good times and in more challenging times, even if that encompasses a withhold vote or disagreement about compensation for the year in review.

Executive Compensation

Erica: What about companies that are looking to engage because they have specific questions or concerns, such as on executive compensation?

Ben: Companies often seek to engage with us after a low or failed say-on-pay vote or in response to a majority-supported shareholder proposal. Our view is that when companies come to us and say — *we have a new plan for compensation after this challenging vote, what do you think?* — we view that as a missed opportunity. We want these discussions to be around giving feedback on a company's general approach to executive compensation so that our view can be taken into account, rather than a box-ticking exercise after the revised plan has already been developed. We expect compensation committees to develop an effective plan that will achieve the company's goals, tie closely to strategy and align with investors' interests.

I want to be clear about a related point — we generally don't want to focus all of our calls on a single issue, namely executive compensation. There are so many important and financially material ESG issues we want to focus our direct engagements on. I would rather start the conversation on strategy, including how ESG material factors are overseen and managed, and then dig in to understand how incentives have been developed to support the execution of that strategy.

Erica: What are the primary reasons that SSGA votes against executive compensation?

Ben: One of the main reasons we vote against pay is due to the lack of alignment with long-term strategy and long-term shareholder interests. In our view, the most effective way to attain this alignment is to give executives equity-based compensation in a form that exposes the amount actually received by the executive to the performance of the company's stock for a long period of time. Robust, minimum stock ownership guidelines can further bolster this alignment.

We are willing to be more flexible with what the ratio of PSUs to RSUs are with longer periods, but companies should strive to put as much pay tied to stock price performance, and with the same risks experienced by shareholders, as the compensation committee is comfortable with, balancing retention and other needs. We are rethinking what a "good" executive compensation plan looks like and we plan to further refine our views on how companies may need to adjust their practices to achieve that goal.

This year we voted against more compensation plans than in prior years, which was the result of a combination of a few different factors. In the summer of 2020, we put out guidance on our expectations for executive compensation practices during the pandemic. This past proxy season, we were surprised by the numerous situations where we saw the use of upward discretion, especially in light of furloughs and lay-offs. We also expected downward discretion to be used more frequently in situations where performance related to the pandemic was extraordinary, but not ultimately sustainable.

From our perspective, discretion is not inherently bad — it can be used in a productive way and that's the responsibility of compensation committees. But, when discretion is used, or there's a deviation from the plan, there needs to be robust disclosure on the committee's decision-making process. That's a critical component of our analysis.

Erica: What is SSGA's view on ESG metrics in compensation programs?

Ben: We are agnostic about ESG metrics in compensation plans. Too often are we finding that they are either easily gamed, fluffy, or 'tick the box' metrics. There isn't yet clear evidence showing that the inclusion of these metrics actually leads to better ESG performance. We have pushed so hard over the years towards compensation plans that minimize the principal-agent problem and our concern is that the inclusion of poorly crafted ESG metrics could exacerbate it.

If used, ESG metrics need to be tied to strategy, quantifiable, sufficiently challenging and incentivize behavior that is clearly articulated in companies' disclosure. In addition, given ESG is inherently long term, our view is that ESG metrics should be part of the long-term program. We will likely provide more clarity on this topic in the future.

Overboarding

Erica: Let's shift to director commitments, an increasing focus for companies and investors. SSGA tightened its policy on overboarding in 2020 — what has been your experience these past two proxy seasons?

Ben: Directors have a challenging role and the topics that they are being asked to oversee have increased in scope and become more complex. Engagement culture, not only with shareholders but with internal and external stakeholders, has placed more demands on their time. We have taken a bright line approach to overboarding because we do not necessarily want to make a subjective call comparing one directors' performance to another. But we have been listening to companies as well and want to be pragmatic about how we approach this policy.

One idea we are considering to go into effect for the 2022 proxy season is to provide more guidance within our policy to clarify that it is the board's decision to determine if a director has enough time to fulfill their commitments. While some companies have policies on outside board commitments in their corporate governance guidelines, it is not a standard practice and not all companies that have such a policy disclose that information in the proxy statement. If companies have a written policy on board commitments and provide more visibility into how nominating and governance committees are assessing directors' time commitments and engagement on the board, that might help us get comfortable moving away from our bright line approach.

Climate Coalitions and Approach to Climate Risk

Erica: What is SSGA's approach to joining and working with the growing number of investor coalitions such as the Climate Action 100+ (CA100+)?

Ben: We are members of the CA100+ as well as the Net Zero Asset Manager Initiative. We are very directionally aligned with both of these organizations and have taken the lead on engagement with two companies for CA100+ — one in the UK and one in Japan — where we have had positive outcomes to date. We think the information sharing in these groups has been effective and we recognize that they require a two-way exchange of information. With that being said, we have our own guidelines and perspectives and we also have the ability to influence change and disclosure standards through our own efforts. So, while we provide perspectives on best practices, we tend to do that separately from group efforts.

Erica: What is next for SSGA when it comes to assessing climate risk?

Ben: One area where I think we can improve is to provide greater clarity about our expectations on what an effective climate transition plan looks like. We are not trying to reinvent the wheel, but we do need to be able to show the commonalities between disclosure frameworks and baseline expectations about what goes into a climate transition plan. That may be done on a sector-specific basis, but we are in the process of developing a set of expectations or underlying themes that we think all companies should take into account. That could include topics like climate strategy and governance, how companies are considering a Just Transition, capital allocation planning, emissions targets, and goals.

We are also assessing the unintended consequences of climate action. Take the Net Zero initiatives many companies are making — we encourage companies to make Net Zero pledges but for us it is much more about how you get there. One issue that is not getting enough attention is aggregate carbon emissions and other asset classes. If investors push a company to achieve Net Zero and they achieve that by selling their 'brown' assets to private equity, that changes nothing from an aggregate carbon emissions standpoint and in many cases it might actually increase it.

Just because a company is "Net Zero" doesn't mean that they, or the broader market, have avoided the negative externalities of climate change. Similarly, if companies offload 'bad' assets to other market actors, we as an investor lose disclosure, our seat at the table, and ultimately our ability to influence and hold companies accountable. That results in a private benefit but a social cost.

I think we also need to shift the conversation around these issues from a binary lens — brown and green — to one that encourages directional progress. By shaming brown assets and neglecting the fact that in the near term we will need fossil fuels that have to be supplied from somewhere, we're missing the forest for the trees.

As a universal owner that holds more than 13,000 companies, we want to use our ability to influence and support companies transitioning from dark to light brown as it may be more impactful than a company that is going from green to darker green. We are open to those 'dirty' companies that are committing to make measurably greener outcomes because that may be more impactful than simply pushing them to divest to the private sector.

Shareholder Proposals

Erica: While we saw significantly higher support for E&S-focused shareholder proposals this year, SSGA has been relatively consistent in its support for these proposals over time. Can you give us some insight into why you don't support certain proposals?

Ben: We don't tend to support proposals that are too prescriptive on business strategy or capital allocation — we elect directors to set the strategy and oversee risks and opportunities and feel it is more appropriate to hold them accountable through director votes. We also are unlikely to support proposals if the company is already providing disclosure aligned with our expectations.

We are seeing more proposals around HCM, social issues and the governance of environmental and social issues. These track the broader evolution of proposals which used to be primarily around disclosure but are now around oversight of topics such as climate lobbying. This pattern is evolving quickly on the social side and we expect to see more of those this coming year. If we see a proposal type that seems like it will become more prominent, we try our best to publish our expectations and framework for evaluating that proposal. We've done that in the past with political participation, pay gap, and racial equity audit proposals, among others.

Companies may agree or disagree with our expectations, but ultimately I think they appreciate that we are consistent in our approach and maintain our overarching voting philosophy year-over-year even as our policies evolve. The increased level of support for shareholder proposals this past year will empower and embolden proponents and I think that will lead to an increase in the number of proposals. Some will be well crafted and others will not warrant our support, but we do intend to be clear about how we analyze them.

This new landscape is going to be a challenge for directors – while many of these proposals can bring up important issues and spark conversations about whether current practices are meeting market expectations, others may be duplicative, overly prescriptive, or poorly crafted. We strive to be as transparent as possible about how we analyze shareholder proposals to provide directors with clarity (and by that I mean predictability) into our voting decisions.

Diversity Equity & Inclusion (DE&I)

Erica: The final topic we wanted to touch on is DE&I. Let's start with disclosure of EEO-1 data, which you first called for in August of 2020 and then added as a voting policy in January 2021. Now that a number of companies are disclosing this information, how strictly will you enforce the policy and how will you use the information once you have it?

Ben: When we wrote to board chairs in August of last year, we made clear that EEO-1 disclosure was part of a broader set of expectations that we had for companies on their racial and ethnic diversity. That starts with strategy, setting goals, providing metrics, ensuring board engagement and effective oversight. Our policy that goes into effect in 2022 (announced in 2021) is clear — if an S&P 500 company does not disclose its EEO-1 report, we will hold compensation committee chairs accountable.

Since publishing our guidance we have held more than 200 engagements on this topic and companies have rightfully raised some concerns — that the data is not the whole picture, that it is not efficient to disclose that along with their own data. But, in our view, every company is already collecting this data and though it may not be how the company views its workforce's racial and ethnic makeup, it does provide a comparable baseline framework. We fully encourage companies to add their own complementary narrative and disclosure to show why other measures are more important, how the board is looking at this issue or how the company views its workforce composition.

Erica: In recent years, there's been a shift in the broader narrative around board diversity from disclosure to representation. What's SSGA's longer-term vision on board diversity?

Ben: Our underlying goal in all of our efforts around improving diversity, equity and inclusion is to promote diversity of thought. That's why we are so focused on gender, racial and ethnic diversity. A lot of research points to the fact that once a critical mass of diversity of thought is reached, it enhances the ability of that group to achieve better outcomes. We have a policy coming online this year to vote against nominating and governance committee chairs at S&P 500 and FTSE 100 companies that do not have at least one director from an underrepresented community on their boards. We are looking at how we can continue to enhance our voting guidelines and disclosure expectations on this topic, and how they might include additional dimensions of diversity and inclusion. As we approach the five-year anniversary of the Fearless Girl campaign, we know that these initiatives can have an impact, which is why we are continuing to make it a focus.

Erica: You recently published a report with Russell Reynolds and the Ford Foundation on board oversight of racial and ethnic DE&I. What is your current thinking about the role of the board in setting and overseeing these initiatives?

Ben: The genesis of that report was an exercise at the request of State Street Corporation when it launched its "10 Actions" to address racism and inequality earlier this year. When we set out to do that research, we found that there just wasn't a lot of good information out there on the topic of what relevant risks and opportunities boards should be overseeing on the topic. Our interviews with over 25 leading directors in the US and UK led us to establish 10 recommendations for boards, including establishing KPIs on racial equity, engaging with relevant stakeholders and focusing on the potential impacts of a company's products and services on communities of color.

One of our learnings from that project was that directors are not doing enough to oversee risks related to the impact of their company's products and services on communities of color. There was a lot of emphasis on board and workforce diversity, but very little conversation about externalities related to racial equity. Given the increased focus from stakeholders, including investors, on this topic — for example, in the emergence of racial equity or civil rights audits — we think directors are missing an important dimension of risk. Going forward, we expect to learn more from boards about how they're overseeing risks and opportunities related to DE&I in a comprehensive way, beyond the board and workforce. We hope to see the overall conversation move from diversity in terms of representation to also focus on equity and inclusion.

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